TAB Z

Pharma Pricing USA™

A Comprehensive Review of Pharmaceutical Pricing in the Mid-1990s

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SECTION 3: THE NUTS AND BOLTS OF PHARMACEUTICAL PRICING: CONVENTIONS, PATTERNS, TRENDS AND COMPETITION

The competitive pricing environment for pharmaceuticals in the United States is as multi-faceted as the customer base and the number of individual competitors. In few other markets in the world are there so many levels of prices, types of decision makers, or approaches to meeting their perceived needs when it comes to pricing. As such, the complexity of pharmaceutical pricing in this country is substantial.

SECTION 3.1: WHAT IS A PHARMACEUTICAL PRICE?

The price of a pharmaceutical product is often difficult to discern. To begin with, there are several -- and often many -- "prices," depending upon the stage of distribution, the customer, and the basis upon which the price calculation is made.

One person's price is, of course, another person's cost, and although the list prices make for handy comparisons, the wholesaler and the retailer ordinarily must both apply markups to their costs when setting their prices. Thus the price the patient pays, and the price that payers and physicians will be concerned with, reflects the price charged by the company plus the markups applied by two different intermediaries. These markups vary widely, but often predictably, for different products.

The "list price," also called the ex-factory price or wholesale acquisition cost (WAC), represents the price nominally charged by the pharmaceutical company to wholesalers or other non-discount customers. This figure, along with the Average Wholesale Price (AWP), provides the basis for most price comparisons among products.

The AWP is a particularly misunderstood term, but one which continues to have considerable commercial significance despite the near-universal acknowledgment that it rarely is an accurate description of any real price in the marketplace! Therefore, a historical review of the evolution of the AWP is appropriate.

3.1.1 AWP: Historical Background

The so-called Average Wholesale Price remains the most commonly-referenced price for a pharmaceutical product. This is the case despite the fact that the AWP is a complete misnomer: It is neither a true "average" nor a common actual price charged by the

wholesaler. Indeed, a common joke is that the abbreviation actually stands for "Ain't What's Paid." But less than two decades ago, the term was considerably more reflective of reality.

Until the early 1980's, there were several hundred small, independent drug wholesalers in the U.S. Most of these operated within a particular geographic region. Due to the inefficiencies inherent in such a fragmented system, the operating costs were quite high. The average markup above cost by wholesalers to their retail customers (primarily pharmacies) was 20% to 25%, depending on the manufacturer.

During this pre-1980 period, most pharmaceutical manufacturers utilized a wholesaler-only method of distribution to the retail class of trade. But a significant number of large firms, including Upjohn, Merck, Squibb and others, had invested in their own distribution networks and engaged in "direct selling," in addition to indirect sales via wholesalers. By convention, wholesalers added 20% to the price of products from companies following a wholesaler-only policy while adding 25% to the prices of products from those companies who chose to "compete" with the wholesalers.

In the late 1970's and early 1980's, several wholesale drug companies began to acquire smaller competitors. Two companies in particular, Bergen-Brunswig Company and McKesson Drug, expanded significantly. Both became national in scope during this period. By 1994, the number of pharmaceutical wholesalers in the U.S. had dropped to just seventy, operating 232 distribution centers.[1]

The expansion of major wholesale firms also concentrated competition. Before consolidation, most wholesalers had little or no competition within their trading areas, so there was virtually to reduce their markups. As consolidation in the industry increased, trading areas of major wholesalers increasingly overlapped, resulting in increased competition for the retail pharmacies and other pharmaceutical purchasers in each region. The result was a gradual but steady shrinkage in markups by wholesalers.

Additionally, starting in the late 1970's, prices charged by manufacturers began to increase at significant rates, often in excess of overall inflation rates. In retrospect, it is clear that not all of the increase was being passed along to the pharmacy or other purchaser: as described above, wholesalers "swallowed" a significant portion of the manufacturers' price increases. The highly competitive wholesaling industry in effect was subsidizing manufacturers. In addition, the predictability of price increases by some manufacturers, combined with the need by wholesalers to make up for the profit margins foregone by the shrinkage of markups, led many wholesalers to engage in a form of arbitrage: wholesalers increasingly attempted to time their purchases of drugs so that

they bought larger quantities just prior to an anticipated price increase by the manufacturer. Wholesalers were able to profit from this activity because they tended to apply the manufacturer's price increase, as soon as it was announced, to their entire supply of a product - including the portion they had previously purchased at a lower price. Thus, the wholesaler would often purchase a product based on a lower price structure and then sell it based on a higher price structure, capturing the difference as an arbitrage profit.

The interest in forward buying among wholesalers was so great that First DataBank -- a producer and marketer of pharmaceutical list prices and other information -- introduced a desktop system originally designed to help wholesalers engage in this efficient forward-buying or arbitrage. This desktop product is called "PriceProbe." One result of wholesalers' forward-buying was that manufacturers increasingly were experiencing a decline in unit sales in the weeks and even months following a price increase: their anticipated revenue gains from the price increases were shrinking. In a response similar to an "arms race," some manufacturers responded by attempting to make their price increases less predictable.

The combined forces of greater competition among wholesalers and increased forward-buying forced and allowed wholesalers to sell their products with lower markups. Adoption of increasingly sophisticated technology by successful, larger wholesalers produced greater efficiency, which helped wholesalers make a reasonable profit despite the smaller markups. The result is that average wholesaler markups were in the range of 3-4% over WAC by the early 1990s, or 5-6% when the usual 2% discount for prompt payment is taken into account. These figures compare with markups of 20-25% over WAC (22-28% over net) as implied by the published AWP.

While the AWP is no longer the cost paid by retailers, it nevertheless still provides the basis for much retail pricing. Pharmacy Benefit Managers (PBMs) and other payers also still use the AWP in determining reimbursement to the retail pharmacist.